No. 10,908

IN THE

United States Circuit Court of Appeals

For the Ninth Circuit

LENORE S. ROBINETTE,	
	Petitioner,
vs.	
COMMISSIONER OF INTERNAL REVENUE,	
	Respondent.

BRIEF FOR PETITIONER.

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This is a petition for review of a decision of The Tax Court of the United States. The taxes in controversy are income taxes for the taxable period beginning February 1, 1939 and ending December 31, 1939. The deficiency asserted by respondent amounts to $665.92 and this is the amount of tax in controversy.

BASIS OF JURISDICTION OF THE TAX COURT OF THE UNITED STATES AND BASIS OF JURISDICTION AND VENUE OF THE UNITED STATES CIRCUIT COURT OF APPEALS.

Jurisdiction of The Tax Court of the United States arises under 26 U.S.C.A. § 272 and upon timely compliance by petitioner with the provisions of law and

the rules of The Tax Court of the United States issued under 26 U.S.C.A. § 1111. The notice of deficiency in income taxes for the taxable year involved was mailed by respondent to petitioner on January 9, 1943. (R.* p. 9.) Petitioner filed a petition with the Tax Court for redetermination of the asserted deficiency in income taxes set forth in said notice of deficiency on April 5, 1943. (R. p. 9.) On April 27, 1944 the Tax Court issued an opinion and decision in said proceeding that the deficiency in income taxes in the amount of $665.92, as determined by the respondent, was proper. (R. pp. 14-22.) On May 24, 1944 petitioner filed with the Tax Court a motion for rehearing and reconsideration of its opinion and decision in said proceeding. (R. pp. 22-32.) On June 5, 1944 the Tax Court made an order denying said motion. (R. p. 32.)

The jurisdiction of the United States Circuit Court of Appeals for the Ninth Circuit arises under 26 U.S.C.A. § 1141(a) and upon timely compliance by petitioner with the provisions of law and rules of Court issued under 26 U.S.C.A. § 1141(c) (2). On August 31, 1944 petitioner filed with the Tax Court a petition for review of its decision by the United States Circuit Court of Appeals for the Ninth Circuit. (R. pp. 34-40.) Venue of said proceeding is conferred upon this Court by a stipulation in writing between the respondent and petitioner designating this Court as the circuit court of appeals wherein the decision of the Tax Court in said proceeding might be reviewed. (R. pp.

*Refers to printed Transcript of Record.

33-34.) Said stipulation was filed with the Tax Court on August 30, 1944. (R. p. 34.)

On September 28, 1944, pursuant to Rule 75 of the Rules of Civil Procedure of the District Courts of the United States, petitioner served upon respondent and filed with the clerk of the Tax Court a designation of portions of record, proceedings and evidence to be contained in the record on appeal in this proceeding and to be filed with this Court. (R. p. 3.) On October 6, 1944 this Court made an order extending the time within which to file the record on appeal in this proceeding to and including November 10, 1944. A certified copy of said order was filed with the Tax Court on October 11, 1944. (R. p. 3.) Thereafter the clerk of the Tax Court transmitted the transcript of record on appeal and said transcript of record was received and filed by the clerk of this Court on October 31, 1944. (R. p. 66.)

Petitioner served upon respondent and on November 3, 1944 filed with the clerk of this Court a statement of points to be relied on in this appeal and designation of portions of record necessary for consideration thereof. (R. pp. 67-70.)

STATEMENT OF THE CASE.

This case involves the legal question whether upon the liquidation in 1936 of a subsidiary corporation pursuant to the provisions of section 112(b) (6) of the Revenue Act of 1936, the undistributed earnings

or profits of the subsidiary corporation (accumulated after February 28, 1913, and not distributed up to the time of the distribution of its assets in complete liquidation under which no gain or loss to the parent was recognized) may be included in determining whether cash distributions made by the parent corporation in later years to its shareholders were taxable in full as dividends paid out of *its* earnings and profits within the meaning of section 115(a) of the Internal Revenue Code.

The findings of fact of the Tax Court were based upon an agreed statement of facts filed with that Court. (R. pp. 41-51.) The pertinent portion of the facts so found are as follows:

Petitioner is an individual residing in the State of California. During the year 1939 petitioner owned 833⅓ shares of stock of Metropolitan Properties Company (hereinafter referred to as Metropolitan), a California corporation, incorporated November 21, 1924. Said shares had an adjusted basis to petitioner of not less than $80.00 per share.

Cole-French Company was incorporated under the laws of the State of California in December, 1919. On December 24, 1936 Metropolitan was the sole stockholder of Cole-French Company. On that date Cole-French Company was dissolved in a complete liquidation carried out pursuant to the provisions of section 112(b) (6) of the Revenue Act of 1936, under which no gain or loss to Metropolitan was recognized. Immediately prior to its complete liquidation on Decem-

ber 24, 1936 Cole-French Company had undistributed earnings and profits amounting to $244,968.69. Immediately following the dissolution of Cole-French Company, Metropolitan surrendered all of the stock of Cole-French Company to that corporation and in cancellation of all of such stock Cole-French Company distributed to Metropolitan, subject to the liabilities, all of the assets of Cole-French Company. The fair market value of the assets less liabilities received by Metropolitan exceeded at the time of receipt the adjusted basis of the stock of Cole-French Company in the hands of Metropolitan by not less than $200,000, but during 1939 the fair market value of those assets, still retained by Metropolitan, had declined by more than $200,000.

During the taxable period here involved Metropolitan distributed $110,000 to its shareholders. Petitioner received distributions from Metropolitan during the taxable period aggregating $7916.60. Petitioner returned 25.865% of that amount or $2047.63 as taxable income. The return was based upon advice from the corporation that of the total distribution to her, $5868.97 or 74.135%, was a distribution from capital and not from its earnings, profits or surplus.

Respondent determined that all of said distributions received by petitioner constituted taxable income and assessed a deficiency of $665.92. In arriving at said deficiency respondent determined that prior to the distributions of $110,200 by Metropolitan to its shareholders during the taxable period the earnings or profits of Metropolitan available for the payment of

dividends was $283,883.13. In determining the earnings or profits of Metropolitan prior to the distributions during the taxable period here involved, respondent included as earnings or profits of Metropolitan the accumulated earnings and profits of Cole-French Company as of December 24, 1936 in the amount of $244,968.69.

The Tax Court affirmed the determination of respondent that upon the complete liquidation of Cole-French Company in 1936 the earnings and profits of that company should be included in determining whether the cash distributions of Metropolitan in 1939 were taxable in full as dividends paid out of its earnings and profits within the meaning of section 115(a) of the Internal Revenue Code.

The Tax Court based its decision upon *Commissioner v. Sansome* (2 Cir., 1932), 64 Fed. (2d) 931, certiorari denied, 287 U.S. 667, 53 S. Ct. 291, 77 L. Ed. 575, and succeeding cases, particularly *Estate of Howard H. McClintic* (1942), 47 B.T.A. 188.

Prior to the decision of the Tax Court in this case the *Sansome* rule had been applied only to transfers of assets to a corporation in connection with a reorganization and the cases cited by the Tax Court in support of its decision dealt with the application of the rule to that precise situation. The case at bar is the only case in which the *Sansome* rule was applied to an isolated corporate liquidation having no connection with reorganization proceedings, a situation patently different from a corporate liquidation in connection with a plan of reorganization whereby stock

of a predecessor corporation is acquired by a new or successor corporation *in exchange for its own stock* with a purpose of obtaining the assets in liquidation of the predecessor corporation.

The *Sansome* case and the principle of law enunciated therein is not applicable to and in any event is not determinative of the question here involved. Moreover, the Tax Court erred in extending the *Sansome* rule to embrace the isolated liquidation in 1936 of a subsidiary, not a part of a reorganization, and adopting a rule of law in conflict with the intent of Congress as expressed in section 115(h) of the Revenue Act of 1936. The question of the extent to which the *Sansome* rule should be applied was before the Congress in the preparation of the Revenue Act of 1936 and at that time Congress by means of section 115(h) of said Act determined to limit the application of the principle of *Commissioner v. Sansome, supra,* to tax-free reorganizations and not to extend the same to embrace isolated liquidations of subsidiaries having no connection with reorganization proceedings and not involving exchanges or distributions of stock or securities of the so-called parent corporation as was subsequently done by the amendment of section 115(h) in the Revenue Act of 1938.

It is submitted therefore that the *Sansome* rule was not applicable to a liquidation in 1936 of a subsidiary under section 112(b) (6) of the Revenue Act of 1936 and that the 1938 amendment to section 115(h) was not and could not be made retroactive.

ARGUMENT.

THE SANSOME CASE AND SUCCEEDING CASES DEALT EXCLUSIVELY WITH TRANSFERS TO A CORPORATION IN CONNECTION WITH A REORGANIZATION AND PRIOR TO THE PRESENT DECISION THE DOCTRINE OF INHERITED EARNINGS HAD NOT BEEN APPLIED TO AN ISOLATED CORPORATE LIQUIDATION NOT A PART OF A REORGANIZATION. BY CODIFYING THE SANSOME RULE AS THERETOFORE APPLIED IN SECTION 115(h) OF THE REVENUE ACT OF 1936 WITHOUT ENLARGING THE RULE TO APPLY TO CORPORATE LIQUIDATIONS UNDER SECTION 112(b) (6), CONGRESS MUST HAVE INTENDED NOT TO MAKE THE SANSOME RULE APPLICABLE TO A LIQUIDATION IN 1936 UNDER SECTION 112(b)(6). THE 1938 AMENDMENT TO SECTION 115(h) MAKING THE SANSOME RULE APPLICABLE TO LIQUIDATIONS UNDER 112(b) (6) COULD NOT BE APPLIED RETROACTIVELY TO A 1936 LIQUIDATION OF A SUBSIDIARY CORPORATION.

(a) The origin and scope of the Sansome rule.

The *Sansome* case involved a transfer of assets in a tax-free reorganization and did not involve the liquidation of a subsidiary corporation. In that case in 1921 Corporation A transferred all of its *assets* subject to liabilities to newly created Corporation B with additional charter powers in exchange for stock of Corporation B in a non-taxable corporate reorganization under section 202(c) (2) of the Revenue Act of 1921. The stock of Corporation B was distributed to the shareholders of Corporation A, that corporation being thereupon dissolved. After the reorganization the shareholders of Corporation B were the identical persons who had been shareholders of Corporation A with the same proportionate interest in said corporations. Prior to the reincorporation, Corporation A had a large earned surplus available for dividends,

and if Corporation A had made distributions, such distributions would have been received by the shareholders as taxable dividends. Corporation B operated without profit for little more than a year. It then dissolved and in 1923 made distributions in liquidation to said shareholders. Section 201 of the Revenue Act of 1921 which dealt with distributions from earnings or profits and distributions in liquidation, unlike the present statute, taxed such liquidation distributions as dividends to the extent of the earnings or profits of the corporation being liquidated.

The Commissioner treated these distributions as dividends. The taxpayer (a shareholder) contended that the distributions did not constitute taxable dividends since Corporation B had no earnings and profits of its own available for dividends and claimed the right to apply the payments to amortize his cost and pay a tax upon only so much as exceeded his cost. The Board of Tax Appeals held that the distributions were not dividends because not made out of the earnings or profits of Corporation B. The Circuit Court of Appeals reversed. The Board of Tax Appeals determined and the Court conceded that the issuance of stock by Corporation B in exchange for the assets of Corporation A was a capital transaction and that ordinarily subsequent distributions by Corporation B would have been deemed to be distributions of capital. Although Corporation A and its shareholders realized gain or loss upon the exchanges, the Court pointed out that under section 202(c) (2) of the Revenue Act of 1921, such gain or loss was not recognized for income tax

purposes. The Court therefore held that section 202 (c) (2) of the Revenue Act of 1921 should be read as a gloss on section 201 of the Revenue Act of 1921 and held that since the disposition of assets by Corporation A and the exchange of stock by the shareholders did not result in the recognition of gain or loss to Corporation A or to its shareholders under section 202(c) (2) the earnings or profits of Corporation A remained for purposes of distribution, earnings or profits of its successor, Corporation B, in liquidation, under section 201.

Judge Learned Hand, speaking for the Court, stated the Court's holding as follows (60 Fed. (2d) 931 at page 933):

> "* * * we hold that a corporate reorganization which results in no 'gain or loss' under section 202(c) (2) * * * does not toll the company's life as a continued venture under section 201, and that what were 'earnings or profits' of the original, or subsidiary, company remain, for purposes of distribution, 'earnings or profits' of the successor, or parent in liquidation."

Since the *Sansome* case involved an exchange in reorganization effected merely to secure additional charter powers with assets, liabilities and stockholders unchanged and did not involve the liquidation of a subsidiary corporation the case can hardly be construed as holding that the principle therein enunciated applies to an isolated liquidation of a subsidiary, not a part of a reorganization.

While it is true, as observed by the Tax Court (R. p. 15), that the doctrine of inherited earnings established in the *Sansome* case has been applied in a variety of circumstances, the application of the doctrine has always been restricted to a factual situation involving a non-taxable reorganization wherein assets of a predecessor corporation were transferred to a successor corporation, the shareholders of the predecessor corporation exchanging stock in such corporation for stock in the successor corporation.

> *United States v. Kauffman* (9 Cir., 1933), 62 Fed. (2d) 1045;
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> *Helen V. Crocker* (1934), 29 B.T.A. 773;
>
> *Murchison's Estate v. Commissioner* (5 Cir., 1935), 76 Fed. (2d) 641;
>
> *Harter v. Helvering* (2 Cir., 1935), 79 Fed. (2d) 12;
>
> *Reed Drug Co. v. Commissioner* (6 Cir., 1942), 130 Fed. (2d) 288, affirming (1941) 44 B.T.A. 573.

And the Circuit Court of Appeals for the Third Circuit has recently refused to extend the *Sansome* doctrine to a transfer of corporate assets which, while constituting a tax-free reorganization within the meaning of the Revenue Act, nonetheless was atypical in that it involved the introduction of new capital and new stockholders into the corporate picture with consequent changes in the proportionate interest of the old stockholders in the enterprise.

> *Campbell v. United States* (3 Cir., 1944), 144 Fed. (2d) 177.

The Tax Court in its opinion indicates that the rule of the *Sansome* case is equally applicable to an isolated liquidation of a subsidiary corporation, not a part of a reorganization, upon the basis of the decision in *Estate of Howard H. McClintic* (1942), 47 B.T.A. 188. It appears, however, from a reading of the opinion in the *McClintic* case that no new principle was therein announced and that the factual situation there involved is unlike that of this case but is indistinguishable from the situation presented in the *Sansome* case and succeeding cases.

The *McClintic* case involved the acquistion in 1926 by McClintic-Marshall Corporation, a new corporation hereinafter referred to as "McClintic-Marshall", of all the outstanding capital stock of Construction Co., the old corporation, by issuing therefor directly to the stockholders of Construction Co. a like number of its own shares in a non-taxable reorganization within the meaning of section 203(b) of the Revenue Act of 1926. Thereafter and in *what was stipulated to be a part of the same tax-free reorganization,* McClintic-Marshall effected a complete liquidation of Construction Co. so that after the reorganization the new corporation possessed the assets of the old corporation and the shareholders of the new corporation were identically the same persons as the shareholders of the old corporation. In the *McClintic* case the taxpayer contended that McClintic-Marshall not only did not inherit the earnings or profits of Construction Co. but actually realized a loss on the transaction. The Tax Court disposed of this contention by pointing out that in the

type of reorganization there involved the successor corporation never realizes profit or loss nor is any profit or loss recognized to such successor corporation, at page 198, as follows:

> "McClintic-Marshall appears to have acquired all of the stock of the Construction Co., and after becoming the owner of the stock, has effected a complete liquidation of Construction Co. by eventually transferring all of the assets of Construction Co. to itself. It thus received a total of $65,000,000 worth of net assets. Obviously, it has had no loss. It got exactly what it set out to get and has paid for it in its own stock, which stock, at best, was not worth more than $65,000,000. $65,000,000 paid out and $65,000,000 received back results in neither gain nor loss. Thus, actually, McClintic-Marshall had no loss whatsoever upon the acquisition of the assets of the Construction Co. nor upon its liquidation."

It is to be noted that the facts of the *McClintic* case different from the facts of the *Sansome* case only in that in the *McClintic* case the new or successor corporation issued its stock directly to the outstanding stockholders of the old or predecessor corporation in exchange for the stock of the predecessor corporation as a part of a plan of reorganization whereby the successor corporation obtained the assets in liquidation of the predecessor corporation.

In *George Whittell & Co.* (1936), 34 B.T.A. 1070, the Board of Tax Appeals held that a transaction like that involved in the *McClintic* case was a tax-free reorganization under section 112(i) (1) of the Reve-

nue Act of 1928 and was completely analogous to a reorganization like that involved in the *Sansome* case wherein the successor corporation first acquired for its stock the assets of the predecessor corporation and then as a final step in the reorganization plan the predecessor corporation exchanged with its own stockholders the stock of the successor corporation for its own stock. In the *Whittell* and *Sansome* cases as a part of a tax-free reorganization, the successor corporations obtained the assets of the predecessor corporations and the stockholders of the predecessor corporations became stockholders in the successor corporation.

In view of the holding in the *Whittell* case and the stipuation in the *McClintic* case that the liquidation of the subsidiary was a part of the tax-free reorganization, the Court in the *McClintic* case correctly held that the doctrine of inherited earnings established in the *Sansome* case was equally applicable to a non-taxable *reorganization* when the transaction involves the acquisition of the stock of the old corporation by the new corporation in exchange for the stock of the new corporation followed by the complete liquidation of the old corporation as a part of the same non-taxable reorganization, as it is in those instances involving the direct acquisition by the new corporation of the assets of the old corporation and the issuance of stock of the new corporation to the shareholders of the old corporation.

The facts of the instant case are therefore no more analogous to the relevant facts of the *McClintic* case than they are to those of the *Sansome* case.

The isolated liquidation of a corporation, not in connection with a reorganization, presents a factual situation entirely different from that involved in a transfer of corporate assets in connection with a reorganization. In the case of a transfer of assets in a reorganization upon a disposition of its assets the *predecessor* or *transferor* corporation realizes a gain or loss which is unrecognized at the time of the transfer in reorganization. For that reason in the *Sansome* case the Court held that the transferee or successor corporation inherited the earnings and profits of the old corporation to which no gain or loss was recognized. But, in the case of an isolated liquidation, not in connection with a reorganization, the liquidated corporation never realizes gain or loss nor is gain or loss *ever* recognized to that entity. The gain or loss, if any, is realized by the stockholder who turns in his stock. The stockholder, however, is not taxable upon the earnings and profits of the liquidated corporation as such. The *Sansome* and *McClintic* cases were not concerned with the isolated liquidation of a subsidiary corporation not connected with a reorganization and the question whether if the *distributee* corporation received assets in an isolated tax-free liquidation it inherited the earnings of the liquidated corporation was not involved in those cases. In the *Sansome* and *McClintic* cases the distributee corporation was deemed to have issued its stock for the assets so that such corporation could not have realized profit or loss on the transaction. The *Sansome* rule has been applied only in connection with transfers of corporate assets

as a part of a tax-free corporate reorganization wherein the *transferor* corporation realized gain or loss which was unrecognized.

Had the complete liquidation of Cole-French Company occurred prior to January 1, 1936, the gain or loss to Metropolitan would have been recognized but Metropolitan would not have been taxed upon the earnings and profits of Cole-French as such. The liquidation distribution to Metropolitan would have been treated as full payment for the stock of Cole-French Company held by Metropolitan and Metropolitan would have had a recognized gain of not less than $200,000. At the same time Metropolitan would have acquired a stepped-up basis equal to the fair market value of the assets received which basis would constitute a tax benefit upon ultimate disposition of the assets. Likewise any gain to Metropolitan would have increased its earnings and profits but the fact that Cole-French Company may have had earnings and profits would have been entirely irrelevant. The tax of Metropolitan would have been the same regardless of whether the earnings and profits account of Cole-French Company had a surplus or a deficit. What then was the purpose and effect of the enactment of Section 112(b) (6) of the Revenue Act of 1936?

(b) The purpose of section 112(b) (6) of the Revenue Act of 1936 was to encourage the simplification of corporate structures and not to discriminate against corporations receiving property in liquidation as compared with shareholders other than corporations. The effect of said section was merely to postpone the recognition of gain or loss to the distributee corporation until disposition in a taxable transaction of the property received.

In order to facilitate the simplification of corporate structures Congress enacted section 110 of the Revenue Act of 1935 which amended the Revenue Act of 1934 by adding section 112(b) (6) thereto, effective for taxable years beginning after December 31, 1935. (See Senate discussion, Cong. Rec. Vol. 80, p. 8799, Seidman's *Legislative History of Federal Income Tax Laws, 1938-1861,* p. 242.) Although the 1935 law never became operative, section 112(b) (6) of the Revenue Act of (June 23) 1936 being substituted therefor before the completion of any of such taxable years, the 1935 Act is of historical importance in connection with an understanding of the purpose and effect of section 112(b) (6) of the Revenue Act of 1936.

The 1935 Act provided that no gain or loss should be recognized upon the receipt by a corporation of property or money in liquidation of another corporation if the distributee corporation owned at least 80% of the voting stock of such other corporation. Since such liquidations were to be treated as tax-free exchanges, section 113(a) (6) of the Revenue Act of 1934 prescribed that the basis of such property to the parent corporation was to be the substituted basis of the parent's investment in the subsidiary corporation.

The report of the Conference Committee (74th Cong., 1st Sess., H. Rept. 1885, Seidman's *Legislative History of Federal Income Tax Laws, 1938-1861,* p. 292) indicates that the purpose and effect of the 1935 Act was merely to postpone the recognition of gain or loss on the property received in complete liquidation of a subsidiary until the property received on liquidation was ultimately disposed of as appears from the following example set forth in the Conference Committee Report (Seidman, *supra,* p. 293):

> "Case No. 1
>
> Corporation A paid $100,000 for the stock of Corporation B. It liquidates Corporation B and receives on liquidation property worth $200,000 at the date of liquidation. Corporation A has realized a gain of $100,000 from the liquidation, which under the amendment is not recognized. However, the basis of Corporation B's property in the hands of Corporation A will be not $200,000, the value at the time of liquidation, but $100,000, the amount Corporation A paid for Corporation B's stock. Corporation A subsequently sells the property it acquired from Corporation B on liquidation for $200,000. Corporation A will be required to pay a tax in the year of sale on a $100,000 gain."

The foregoing example indicates that under the 1935 Act the earnings and profits of the subsidiary corporation were not to be deemed to be distributed to the parent corporation as earnings and profits but that there was to be merely a postponement of the recognition of gain or loss on the transaction until ultimate

disposition by the parent corporation of the assets of the subsidiary corporation, at which time proper adjustment would be made in the earnings and profits account of the parent.

Since a corporation upon liquidation never realizes gain or loss and its shareholders are never taxable upon the earnings and profits of the liquidated corporation upon their distribution in liquidation, distributions in liquidation are only deceptively similar to exchanges in reorganization. It is purely artificial to attribute to a corporate shareholder the earnings and profits of the liquidated corporation merely because gain or loss to the distributee corporation is postponed. The *Sansome* rule affords no basis for the application of the doctrine of inherited earnings to liquidation distributions as distinguished from reorganization exchanges.

The 1936 amendments to section 112(b) (6) removed certain difficulties arising under the 1935 Act which restricted the simplification of corporate structures by liquidation of subsidiaries. (Senate Discussion, Cong. Rec., Vol. 80, p. 8799, Seidman's *Legislative History of Federal Income Tax Laws, 1938-1861,* pp. 242, 244.)

Congress at the same time enacted section 113(a) (15) of the Revenue Act of 1936 which section provided that the basis of the property received by the parent corporation should be the same basis as it would be in the hands of the transferor corporation instead of the substituted basis prescribed in the 1935 Act. Senator George in explaining this change stated

the reasons therefor as follows (Cong. Rec., Vol. 80, p. 8799, Seidman's *Legislative History of Federal Income Tax Laws, 1938-1861,* p. 244):

> "The protection of the Treasury, as well as sound policy, requires that the property retain the same basis after the liquidation as before."

Apparently it was believed that the transferor's basis for the property distributed to the parent corporation would, in general, impose on the parent corporation a lower basis than that of the stock surrendered, and upon the subsequent disposition of the property in a taxable transaction this would result in greater taxable gain or lesser recognized loss on the transaction than would result from the transferee's substituted basis for the stock. An added reason for the change may have been to overcome to a considerable extent the difficulties which would have arisen under the 1935 Act in allocating the basis of the parent's investment among the various assets of the subsidiary distributed to the parent in liquidation instead of simply taking the transferor's basis as to each asset. (See Art. 113(a)(6)-1 of Regulations 86 as amended to conform to Revenue Act of 1935, T.D. 4626, C.B. XV-1, pp. 61, 74; Montgomery, *Federal Income Tax Handbook, 1936-1937,* p. 242.) In any event it is apparent that the change requiring the parent corporation to use the transferor's basis instead of its own substituted basis was entirely unrelated to the question whether Congress intended that the doctrine of inherited earnings established in the *Sansome* case should apply to liquidations under sec-

tion 112(b) (6) of the Revenue Act of 1936. There is no indication whatsoever that in 1936 Congress intended that upon the liquidation of a subsidiary corporation the earned surplus of the parent should be increased by *both* the earned surplus of the subsidiary and any recognized profit to the parent, computed on the transferor's basis, upon the ultimate disposition of the assets of the subsidiary corporation, thus discriminating against corporations receiving property in a corporate liquidation as compared with shareholders other than corporations.

(c) The codification of the Sansome rule in section 115(h) of the Revenue Act of 1936 not only indicated the traditional scope of the rule but also indicated that in 1936 Congress did not intend the Sansome rule to be applicable to a complete liquidation of a subsidiary corporation pursuant to section 112(b) (6). The 1938 amendment to section 115(h) was not retroactive.

The most compelling factor indicating that in 1936 Congress did not intend that the Sansome rule be applicable to liquidations under section 112(b) (6) of the Revenue Act of 1936 appears from the fact that when section 112(b) (6) was enacted in 1936 to make complete liquidations of subsidiary corporations nontaxable Congress at the same time enacted section 115(h) which codified the rule of the *Sansome* case and confined its application to exchanges in reorganization, the situation to which the rule had been traditionally applied. Since Congress did not at such time enact a like rule with respect to complete liquidations of subsidiaries under section 112(b) (6) it must be assumed that in 1936 Congress did not intend

that the *Sansome* rule should apply to liquidations of subsidiaries not a part of a reorganization. Section 115(h) provided as follows:

> "Section 115(h). *Effect on Earnings and Profits of Distributions of Stock.*—The distribution (whether before January 1, 1936, or on or after such date) to a distributee by or on behalf of a corporation of its stock or securities or stock or securities in another corporation shall not be considered a distribution of earnings or profits of any corporation—
>
> (1) if no gain to such distributee from the receipt of such stock or securities was recognized by law, or
>
> (2) if the distribution was not subject to tax in the hands of such distributee because it did not constitute income to him within the meaning of the Sixteenth Amendment to the Constitution or because exempt to him under Section 115(f) of the Revenue Act of 1934 or a corresponding provision of a prior Revenue Act.
>
> As used in this subsection the term 'stock or securities' includes rights to acquire stock or securities."

It should be noted that section 115(h) only seeks to cover the effect on earnings and profits of a distribution to a "distributee" of (1) the distributing corporation's own stock or securities, or (2) stock or securities of another corporation. The section did not include distributions of assets other than the distributing corporation's own stock or securities or stock or securities of another corporation.

On the other hand, Regulation 94 which accompanied the Revenue Act of 1936 provided as follows:

"Art. 115-11. *Effect of earnings or profits of certain tax-free exchanges and tax-free distributions.*—If, under the law applicable to the year in which any transfer or exchange of *property* after February 28, 1913, was made (including transfers in connection with a reorganization or a complete liquidation under Section 112(b)(6) and intercompany transfers of property during a period of affiliation), gain or loss was not recognized (or was recognized only to the extent of the *property* received other than that permitted by such law to be received without the recognition of gain), then proper adjustment and allocation of the earnings or profits of the transferor shall be made as between the transferor and transferee corporations.

The general rule provided in Section 115(b) that every distribution is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits, does not apply to:

(1) The distribution, in pursuance of a plan of reorganization, by or on behalf of a corporation a party to the reorganization, to its shareholders of *stock or securities* in such corporation or in another corporation a party to the reorganization—

(A) in any taxable year beginning before January 1, 1934, without the surrender by the distributees of stock or securities in such corporation (see Section 112(g) of the Revenue Act of 1932); or

(B) in any taxable year (beginning before January 1, 1936, or on or after such date) in exchange for its stock or securities (see Section 112(b)(3))

if no gain to the distributees from the receipt of such *stock* or *securities* was recognized by law.

(2) A stock dividend which was not subject to tax in the hands of the distributee because either it did not constitute income to him within the meaning of the Sixteenth Amendment to the Constitution or because exempt to him under Section 115(f) of the Revenue Act of 1934 or a corresponding provision of a prior Revenue Act. A distribution described in paragraphs (1) and (2) above does not diminish the earnings or profits of any corporation. In such cases, the earnings or profits remain intact and available for distribution as dividends by the corporation making such distribution, or by another corporation to which the earnings or profits are transferred upon such reorganization or other exchange.

For the purposes of this article, the terms 'reorganization' and 'party to the reorganization' shall, for any taxable year beginning before January 1, 1934 have the meanings assigned to such terms in Section 112 of the Revenue Act of 1932, and for any taxable year beginning after December 31, 1933, and before January 1, 1936, have the meanings assigned to such terms in Section 112 of the Revenue Act of 1934." (Italics added.)

It was not until the Revenue Act of (May 28) 1938, and after the liquidation in 1936 of Cole-French Com-

pany, that Congress sought to give the *Sansome* rule an entirely new application to tax-free liquidations of subsidiary corporations not connected with a reorganization. Section 115(h) as amended by the 1938 Act provided as follows:

> "Section 115(h). *Effect on earnings and profits of distributions of stock.*—The distribution (whether before January 1, *1938,* or on or after such date) to a distributee by or on behalf of a corporation *of* its stock or securities, of stock or securities in another corporation, *or of property or money,* shall not be considered a distribution of earnings or profits of any corporation—
>
> (1) if no gain to such distributee from the receipt of such stock or securities, *or of property or money,* was recognized by law, or
>
> (2) if the distribution was not subject to tax in the hands of such distributee because it did not constitute income to him within the meaning of the Sixteenth Amendment to the Constitution or because exempt to him under Section 115(f) of the Revenue Act of 1934 or a corresponding provision of a prior Revenue Act.
>
> As used in this subsection the term 'stock or securities' includes rights to acquire stock or securities." (Italics added.)

The pertinent portions of Regulations 101 which accompanied the Revenue Act of 1938 are as follows:

> "Art. 115-11. *Effect on earnings or profits of certain tax-free exchanges and tax-free distributions.*—If, under the law applicable to the year in which any transfer or exchange of property

after February 28, 1913, was made (including transfers in connection with a reorganization or a complete liquidation under Section 112(b)(6) and intercompany transfers of property during a period of affiliation), gain or loss was not recognized (or was recognized only to the extent of the property received other than that permitted by such law to be received without the recognition of gain), then proper adjustment and allocation of the earnings or profits of the transferor shall be made as between the transferor and transferee corporations.

The general rule provided in Section 115(b) that every distribution is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits, does not apply to:

(1) The distribution, in pursuance of a plan of reorganization, by or on behalf of a corporation a party to the reorganization, to its shareholders of stock or securities in such corporation or in another corporation a party to the reorganization—

(A) in any taxable year beginning before January 1, 1934, without the surrender by the distributees of stock or securities in such corporation (see Section 112(g) of the Revenue Act of 1932); or

(B) in any taxable year (beginning before January 1, *1938,* or on or after such date) in exchange for its stock or securities (see Section 112(b)(3))

if no gain to the distributees from the receipt of such stock or securities was recognized by law.

(2) *The distribution in any taxable year (beginning before January 1,1938, or on or after such date) of stock or securities, or other property or money, to a corporation in complete liquidation of another corporation, under the circumstances described in Section 112(b)(6) of the Revenue Act of 1936 or Section 112(b)(6) of the Revenue Act of 1938.*

(3) * * *

(4) A stock dividend which was not subject to tax in the hands of the distributee because either it did not constitute income to him within the meaning of the Sixteenth Amendment to the Constitution or because exempt to him under Section 115(f) of the Revenue Act of 1934 or a corresponding provision of a prior Revenue Act.

A distribution described in *paragraph* (1), (2), *(3) or (4)* above does not diminish the earnings or profits of any corporation. In such cases, the earnings or profits remain intact and available for distribution as dividends by the corporation making such distribution, or by another corporation to which the earnings or profits are transferred upon such reorganization or other exchange. *In the case, however, of amounts distributed in liquidation (other than a tax-free liquidation or reorganization described in paragraph (1), (2), or (3) above) the earnings or profits of the corporation making the distribution are diminished by the portion of such distribution properly chargeable to earnings or profits accumulated after February 28, 1913, after first deducting from the amount of such distribution the portion thereof allocable to capital account.*

For the purposes of this article, the terms 'reorganization' and 'party to the reorganization' shall, for any taxable year beginning before January 1, 1934, have the meanings assigned to such terms in Section 112 of the Revenue Act of 1932; for any taxable year beginning after December 31, 1933, and before January 1, 1936, have the meanings assigned to such terms in Section 112 of the Revenue Act of 1934; *and for any taxable year beginning after December 31, 1935, and before January 1, 1938, have the meanings assigned to such terms in Section 112 of the Revenue Act of 1936.*" (Italics added.)

The omitted portion deals with distributions described in section 371 made in obedience to orders of the Securities and Exchange Commission; the italics in the above article indicate new matter.

It must again be noted that section 115(h) of the Revenue Act of 1936 involves distributions of *stock* or *securities* only and was framed to give effect to the *Sansome* rule as traditionally applied to transfers in connection with a reorganization. Section 115(h) of the Revenue Act of 1936 did not expressly or by implication purport to cover distributions of *property* in connection with the complete liquidation of a subsidiary pursuant to section 112(b) (6) of the 1936 Act.

It is significant that the first suggestion or intimation that the *Sansome* rule might be applicable to liquidations under section 112(b) (6) of the Revenue Act of 1936 appears in Article 115-11 of Regulations 94 set forth above (pp. 23-24) and which accompanied

the 1936 Act, in which regulation respondent purported to enlarge upon section 115(h) of the 1936 Act by including within its scope all "property" and not merely stock or securities. On the basis of such enlargement which was clearly unauthorized the regulation sought to do what the Courts had never done and what the statute did not do, namely, to apply the *Sansome* rule to complete liquidations under section 112(b) (6) of the Revenue Act of 1936.

The question whether the *Sansome* rule should be made applicable to a liquidation of a subsidiary under section 112(b) (6) and consummated prior to the 1938 Amendment to section 115(h) must be considered against the background of decisions applying the *Sansome* rule and the statement of the rule in section 115(h) of the Revenue Act of 1936. This question cannot be foreclosed by assuming that the principle of the *Sansome* rule would have been applicable to corporate liquidation had section 115(h) never been enacted. To read section 112(b) (6) of the Revenue Act of 1936 as a gloss upon section 115(a) when Congress in enacting section 112(b) (6) had at the same time in section 115(h) enacted its understanding of the *Sansome* rule appears to be a form of judicial legislation in which the Courts have often announced they cannot and will not indulge. It must be assumed that in failing to provide in section 115(h) of the 1936 Act that the doctrine of inherited earnings should also apply to liquidations of subsidiary corporations under section 112(b) (6), Congress did so because it did not consider the *Sansome* rule applicable to that entirely different

situation. Had Congress intended in 1936 to make the *Sansome* rule applicable to 112(b) (6) liquidations it would have used the appropriate terminology later used in the 1938 Amendment to section 115(h). (*Wallace v. Commissioner* (9 Cir., 1944), 144 Fed. (2d) 407, 410.) Indeed, until the Treasury promulgated Article 115-11 of Regulations 94 there was absolutely no suggestion either by judicial decision or statute that the *Sansome* rule applied to liquidation distributions not a part of a reorganization.

Under the circumstances the enactment of the 1938 Amendment clearly indicates a change in the law as theretofore existing. It would appear therefore that the basic question should be whether a Court may by judicial innovation extend the *Sansome* rule to cover the entirely new and different situation involved in the liquidation in 1936 of a subsidiary under section 112(b) (6) despite the congressional intent as expressed in section 115(h) of the Revenue Act of 1936. Petitioner respectfully submits that in view of the enactment of the *Sansome* rule in section 115(h) the Tax Court erred in treating section 115(h) as entirely irrelevant to a liquidation in 1936 of a subsidiary corporation. Moreover, since Congress sought to state its understanding of the *Sansome* rule in section 115(h) it is respectfully submitted that the Tax Court erred in enlarging section 115(h) to embrace corporate liquidations not a part of a reorganization and in effect applying Article 115-11 of Regulations 94 to a situation outside the scope of section 115(h).

If the *Sansome* rule as enacted by Congress in section 115(h) prior to the 1938 Amendment did not apply to distributions of money or property in connection with a complete liquidation, Article 115-11 of Regulations 94 in so far as it purported to prescribe a rule that a distribution of money or property in a complete liquidation to a distributee corporation increased the earnings or profits of said corporation was without statutory authority.

It is well settled that a regulation which is broader than the statute which it purports to interpret is invalid and "a mere nullity". The rule is stated by the United States Supreme Court in *Manhattan General Equipment Co. v. Commissioner* (1936), 297 U.S. 129, 56 Sup. Ct. 397, 80 L. Ed. 529, at page 129, as follows:

> "The power of an administrative officer or board to administer a federal statute and to prescribe rules and regulations to that end is not the power to make law—for no such power can be delegated by Congress—but the power to adopt regulations to carry into effect the will of Congress is expressed by the statute. A regulation which does not do this, but operates to create a rule out of harmony with the statute, is a mere nullity. Lynch v. Tilden Produce Co., 265 U.S. 315, 320-322, 68 L. ed. 1034-1036, 44 S. Ct. 488; Miller v. United States, 294 U.S. 435, 439, 440, 79 L. ed. 977, 980, 981, 55 S. Ct. 440, and cases cited. * * *"

See also

Helvering v. Janney (1940), 311 U.S. 189, 194, 61 S. Ct. 241, 85 L. Ed. 118.

Respondent contended in the Tax Court that the 1938 Amendment to section 115(h) merely sought to clarify the existing law which respondent contended made the *Sansome* rule applicable in 1936 to complete liquidations of a subsidiary. If the Tax Court assumed that the 1938 Amendment to section 115(h) merely clarified but did not extend the section as previously enacted by Congress, it is clear from the authorities that such rule of statutory construction was unwarranted. The enlargement of section 115(h) of the Revenue Act of 1936 to include distributions of property in complete liquidation under section 112(b)(6) was not a mere clarification but was a complete amendment of the statute to apply to an entirely new and unrelated factual situation to which the *Sansome* rule had never theretofore been applied.

In *Commissioner v. Windrow* (5 Cir., 1937), 89 Fed. (2d) 69, at page 71, the Court stated the rule as to statutory construction as follows:

> "Courts and administrative agencies are bound to enforce the plain words of the statute although there may be reason to think, in view of the general legislative purpose that some other provision would have met with favor if the Legislature had called it to mind."

In *Commissioner v. Kay Mfg. Corp.* (2 Cir., 1941), 122 Fed. (2d) 443, respondent likewise argued that section 115(h) of the Revenue Act of 1936 covered distributions of property as well as stock or securities. In answer to this argument the Circuit Court of Appeals stated at page 445:

"The argument is buttressed by reference to Section 115(h). As this deals only with stock or securities we are unable to see its relevance. It is true that in the Revenue Act of 1938 Section 115(h), 26 U.S.C.A. Int. Rev. Acts, page 1057, was broadened to include money or property, but this is of slight consequence in interpreting the earlier law. See Wild v. Commissioner, 2 Cir., 62 F.2d 777, 780. * * * It should not be overlooked that the Revenue Act of 1936 was intended not only to raise revenue but also to encourage the simplification of corporate structures. See the President's message to Congress, H.R. No. 1681, 74th Cong. 1st sess."

Article 115-11 of Regulations 94 cannot serve as a basis for applying the *Sansome* rule to a liquidation in 1936 of Cole-French Company.

In the recent case of *Sabine Transp. Co., Inc. v. Commissioner* (5 Cir., 1942), 128 Fed. (2d) 945, Judge Hutcheson dealt with the power of the Commissioner by regulation to read words into or out of the revenue laws in a manner contrary to the expressed provisions of the statute, as follows (page 947):

"We think it clear that in attempting, by speculating as to what Congress intended to do except as that intent was expressed in the statute, to rationalize out of the section the comprehensive words which specifically grant the deduction, the Commissioner is attempting to have us arrogate to ourselves the function of rewording rather than of construing and applying the statute. The construction of a statute to make it carry out the intent its words import is one thing. The con-

> struction of it to bring it nearer to the thought of administrator or court, or of some particular section of public opinion, as to what Congress intended or ought to have intended, or that the law would better serve its purpose if it were drawn that way, is quite another. However, we need not further labor the point here, for in Helvering v. Credit Alliance Corp., April 27, 1942, 62 S. Ct. 989, 992, 86 L. Ed. ......, the Supreme Court rejecting the same kind of reasoning as to a dividends paid credit claimed under Section 27(b) (sic) of the Revenue Act of 1936, and declaring invalid a regulation which contravened the plain terms of the statute, has set the matter at rest. Definitely reaffirming the principle that it is for the courts not to write but to enforce a statute, the court said: '*But we cannot, as the Government suggests, read into the section, as it stood when the transaction took place, an intent derived from the policy disclosed by the subsequent amendment.*'" (Italics added.)

The foregoing construction of section 115(h) of the Revenue Act of 1936 is in accord with the position taken by the Supreme Court in *Helvering v. Credit Alliance Corp.* (1942), 316 U.S. 107, 62 S. Ct. 989, 86 L. Ed. 1307, affirming 122 Fed. (2d) 361. It is true as the Tax Court observes in its opinion in the instant case (R. p. 21) that the *Credit Alliance* case was concerned with the question whether the liquidated subsidiary should be denied a dividend paid credit under section 27(f) of the Revenue Act of 1936 by reason of the fact that the distribution in liquidation under section 112(b) (6) did not constitute a taxable divi-

dend in the hands of the distributee corporation and the Courts in that case were not called upon to consider whether under the *Sansome* rule the earnings and profits of the liquidated subsidiary would be attributable to the distributee corporation. However, the statements of the Courts in the *Credit Alliance* case are certainly of significance with respect to the scope of section 115(h) and the effect of the 1938 Amendment thereto.

In the *Credit Alliance* case the Commissioner argued that *since* under the *Sansome* rule the distributee corporation inherited the earnings of the liquidated subsidiary the liquidated subsidiary should be deemed not to have distributed such earnings under section 27(f). It is to be noted that this argument assumes the precise issued involved in this case. The remarks of the Circuit Court of Appeals which *assumed* that the *Sansome* rule would apply to the distribution of earnings or profits in the hands of the distributee were made in answer to the Commissioner's argument, without giving a complete consideration to the effect of section 115(h) of the Revenue Act of 1936 on subsidiary liquidations. The Court, in effect, stated that *assuming* the *Sansome* rule applicable to the distributee corporation, the liquidated subsidiary was nevertheless entitled to a dividend paid credit under section 27(f). That the Court did not, however, dispose of the question whether the *Sansome* rule was applicable to a complete liquidation in 1936 of a subsidiary corporation under section 112(b) (6), and in fact raised a doubt as to such applicability, appears

from the following statement, at 122 Fed. (2d) 361, 365:

> "The Commissioner's argument refers also to Section 115(h) of the Act, 26 U.S.C.A. Int. Rev. Acts, page 870, which provides that a distribution to a distributee by a corporation of its stock or securities, or stock or securities in another corporation, shall not be considered a distribution of corporate earnings or profits if no gain to the distributee from the receipt of such stock or securities was recognized by law. It is said that this section is an express legislative recognition of the principle of Commissioner v. Sansome, supra, as indeed it is, and hence a similar restriction, although not expressed, should be implied in Section 27(f) so that only those liquidating distributions which give rise to taxable gains in the hands of the distributee should be treated as taxable dividends paid.
>
> In answer to this argument it is sufficient to say that the government adds no strength to its position by pointing out that Section 115(h) of the Act of 1936 also involves a recognition of the principle of the Sansome case already considered above. Whether the same result would be reached under Section 115(h) of the Act of 1938, which adds tax-free distributions of 'property or money' to the category of transactions not to be considered as distributions of earnings or profits, we have no occasion now to consider. The reference to the transfer or exchange of 'property' in Article 115(h) of Treasury Regulations 94, promulgated under the Revenue Act of 1936, was obviously unauthorized if it was intended as an enlargement of the scope of the corresponding section of the Act."

The Supreme Court, in the same case, likewise expressed its disapproval of the Commissioner's contention that the 1938 Amendment to section 115(h) made said section applicable to a 1936 liquidation of a subsidiary, saying, 316 U.S. 107, 112:

> "The petitioner points out that the Revenue Act of 1936 introduced a new policy,—to tax undistributed earnings in order to prevent a taxpayer from accumulating untaxed surplus by forcing the payment of dividends which become taxable in the hands of the distributee. This is true, but it is also true that the Act made distributions to parent corporations nontaxable in order to encourage the simplification of corporate structures. It was avowedly for this reason that § 112(b)(6) provided that no gain or loss to the parent company should in such case be recognized, and it may well be that subsection (f) of § 27 was inserted with the same purpose. The Government insists that as § 115(h) provides that a distribution of the taxpayer's stock or securities, or those of another corporation, shall not be considered a distribution of earnings or profits of the taxpayer if no gain to the distributee from the receipt of such stock or securities is recognized by the law, subsection (f) must be read in the light of the policy thus declared by § 115(h). *The latter section is irrelevant to this controversy because the distribution here was in property and money and not in stock or securities. Section 115(h) was amended in 1939 subsequent to the consummation of the transaction here in question to include money or property, but we cannot, as the Government suggests, read into the section, as it stood when the transaction took place, an intent derived from the policy disclosed by the subsequent amendment."* (Italics added.)

Since the *Sansome* rule was traditionally applicable only to exchanges in reorganization and Congress in enacting section 115(h) of the Revenue Act of 1936 did not enact a like rule with respect to complete liquidations of subsidiary corporations the Tax Court erred in reading into section 115(h) "an intent derived from the policy disclosed by the subsequent (1938) amendment" to that section. (See *Helvering v. Credit Alliance Corp., supra,* 316 U.S. 107, 112.)

It is respectfully submitted that the doctrine of inherited earnings was not applicable to the complete liquidation in 1936 by Cole-French Company pursuant to section 112(b) (6) of the Revenue Act of 1936. Accordingly, it was error to increase the earnings and profits of Metropolitan by the earnings and profits of Cole-French Company at the date of its complete liquidation.

Dated, San Francisco, California,
December 27, 1944.

Respectfully submitted,
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